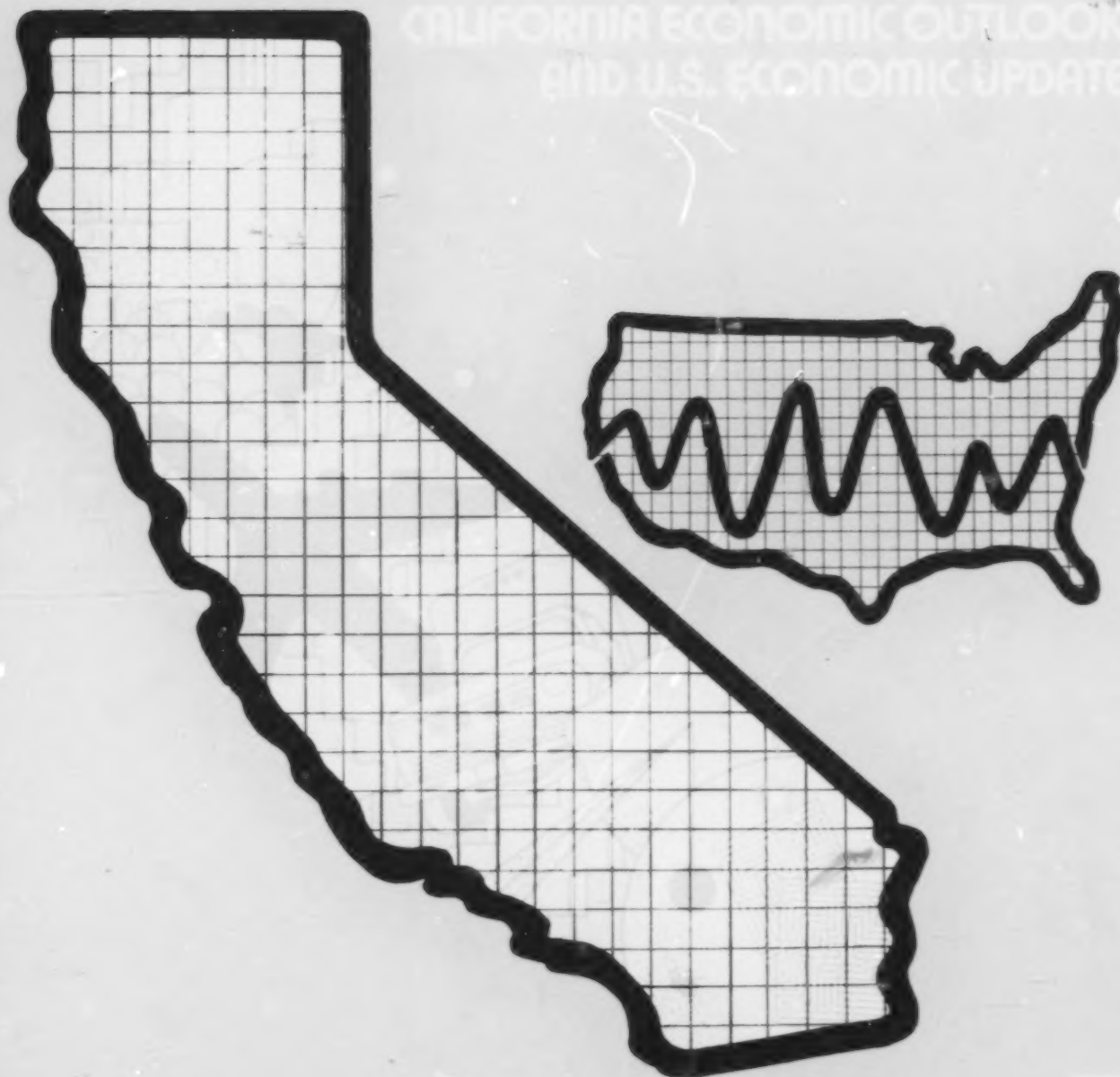


ECONOMIC REPORT

FALL 1982

CALIFORNIA ECONOMIC OUTLOOK AND U.S. ECONOMIC UPDATE



SECURITY PACIFIC NATIONAL BANK

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Number 72

This report highlights the near-term outlook for the California economy through 1985, and includes a near-term update of the U.S. economy.

The next issue of the ECONOMIC REPORT will discuss the international outlook. It is scheduled for release in January, 1985.

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THE CALIFORNIA NEAR-TERM OUTLOOK

OVERVIEW

Following a very sluggish 1982, real economic activity in California surged ahead in 1983 and continued its strong growth trajectory during the first half of 1984. Real gross state product, a measure of the inflation adjusted value of output of the state's economy, increased 4.1 percent in 1983 after a decline of -1.3 percent in 1982. For 1984 real gross state product is projected to increase 8.5 percent, followed by a slower, but still impressive gain of 5.3 percent in 1985.

Virtually all sectors of the state's economy shared in the impressive expansion, with the state's residential housing industry predominantly in the spotlight. The disastrous level of the new housing unit authorizations recorded for 1982, at just over 84 thousand units, was followed by a 100 percent increase in the following year, to 186.4 thousand units. It is presently estimated

that 1984 will see an additional 15 percent increase, to 194.8 thousand units. For 1985, however, it is estimated that new housing units authorizations will decline to 151 thousand units.

The state's labor markets also showed the effects of a strong recovery in economic activity. After averaging in the neighborhood of 11 percent in late 1982 and early 1983, the state's unemployment rate registered almost uninterrupted declines through the first half of 1984, when the unemployment rate declined to a level of 7.5 percent. The July 1984 unemployment rate showed a surprising upward move to 8.2 percent, but July's figure is likely an aberration. It is anticipated that civilian employment will continue to grow at a healthy pace through at least the first quarter of 1985 before the general easing in overall economic activity introduces an easing in statewide job growth and begins to put

GROSS STATE PRODUCT AND PERSONAL INCOME

(Billions of Dollars)
Quarterly Detail, 1984-1985

	1984F				1985F			
	I	II	III	IV	I	II	III	IV
Gross State Product	429.3	447.7	459.9	471.8	483.1	492.3	500.0	508.1
1972 Dollars	189.4	195.9	199.4	202.6	205.1	207.0	208.1	208.8
Personal Income	354.6	366.5	375.9	385.5	394.9	402.8	411.1	419.0
Disposable Personal Income	304.5	314.7	322.1	330.0	338.5	345.2	352.0	358.6
1972 Dollars	135.7	139.5	141.7	143.8	146.1	147.5	148.8	149.8
Annual Rates of Change:								
Gross State Product	10.5	18.3	11.3	10.8	9.9	7.8	6.4	6.6
1972 Dollars	6.6	14.5	7.3	6.7	5.1	3.7	2.1	1.4
Personal Income	11.1	14.1	10.7	10.6	10.1	8.3	8.4	8.0
Disposable Personal Income	11.5	14.1	9.7	10.2	10.7	8.2	8.1	7.7
1972 Dollars	7.6	11.7	6.4	6.2	6.4	4.0	3.6	2.7

F = Forecast

pressure on the unemployment rate. Current projections indicate that over 650 thousand new jobs will have been created in California during the 1984-1985 period.

As might be expected, the state's broad gains in employment have led to sharp growth in total personal income as well. After respective increases in total personal income of 6.5 and 7.1 percent in 1982 and 1983, income growth of over 11 percent is forecast for 1984, followed by a 1985 gain of just under 10 percent. Moreover, the relatively low rates of inflation that have prevailed, particularly during 1983 and 1984, have translated those income gains into very impressive increases in real terms. The pervasive improvement in California's employment and personal income measures has been extended to the state's retail markets as well. Taxable sales in the state showed a 1983 increase of 9.4 percent after a decline of -0.3 percent in 1982. It is expected that a high level of consumer optimism will continue through 1984, with a gain of 13.5 percent projected in total taxable sales for the year. Although the expansion in consumer spending is likely to ease in 1985, especially during the second half of that year, a respectable 8.5 percent growth rate is probable for that year.

In summary, the California economy registered a broad and sustained recovery in the wake of the deep 1981-82 recession, and that recovery is expected to continue at least through 1985. As projected in the 1983 edition of the ECONOMIC REPORT, the state has once again been able to outperform the nation as a whole and is expected to continue to do so during the course of the present expansion. Virtually all sectors of the California economy have benefited from the rebound in growth. Later sections of this report will review in greater detail the patterns of economic activity, past and projected, that have been identified for the state's key indicators.

EMPLOYMENT TRENDS

California labor market trends have characteristically provided one of the most comprehensive measures of the state's economic vitality, giving a reasonably concise assessment of the state's economic strengths and weaknesses. In particular, developments in the establishment survey of non-agricultural industries' employment totals give a very good picture-window scan of the sectoral impact of business cycles. Looking first at the broader measures of the state's employment

scene, the percentage of persons in the civilian labor force who are unable to find work, it becomes clear that the three-year timespan 1980-82 was one of deteriorating labor markets. The economic expansion that followed the 1974-75 recession resulted in the state's unemployment rate declining to 5.9 percent in January 1980 from its recession peak of 10 percent in March 1975. From that January 1980 trough, the state's unemployment rate continued to climb until the end of 1982, reaching a new high of 11.1 percent in both November and December of that year.

The strength of the recovery in California's economic activity is underscored by the decline in the state's unemployment rate to 7.5 percent of the civilian labor force in June 1984. Further, it is expected that the unemployment rate will continue to decline, on average, through the end of 1984, leveling out in the first quarter of 1985, followed by a modest increase in subsequent quarters of 1985. On a fourth quarter to fourth quarter basis, total civilian unemployment in the state increased over 37 percent in 1982, but declined nearly 24 percent in 1983 and over 17 percent in 1984. It is currently projected that total civilian unemployment will increase just 4.5 percent in 1985. Stated in absolute terms, total civilian employment in California will have grown by about 1.3 million jobs from the fourth quarter of 1982 through the end of the forecast period-fourth quarter 1985.

Trends in total nonagricultural employment in the state also underscore the strength of the expansion. During 1984 alone, the number of nonagricultural jobs in California expanded by 500 thousand. Despite the anticipated slowing in job growth during 1985, it is still foreseen that an additional 428 thousand nonagricultural workers will find jobs. Importantly, the improvement in nonfarm employment was very nearly across the board in 1984, with only transportation and public utilities showing a decline. All of the major industry categories will register job growth in 1985. The fastest growing industry category during 1984 and 1985, in terms of job gains, is forecast to be the construction industry, with increases of 13.6 and 6.3 percent, respectively. Construction industry employment in 1985 will average an estimated 85 thousand workers greater than during 1982. It is important to note, however, that the residential building industry is likely to show signs of slowing growth rates from the second half of 1984 through the forecast period, and that slowing will also be evident in the rate of increase in construction employment.

The service industry category and the finance, insurance, and real estate group also represent areas of exceptional employment growth during the 1984-85 period. The services industry, which accounts for almost one quarter of the nonagricultural employment total in California, continued to grow even during 1982, when all other major sectors, excluding mining, registered declines. The government sector, particularly state and local, will continue to be one of the weakest among nonfarm employment groups, despite the apparent easing in the statewide budget situation. Although growth is expected during the 1984-85 span, there will continue to be pressure to hold down government job gains.

In the following sections of this report the outlook for a number of the state's primary industry groups will be examined at length, including: construction, aerospace, agriculture, international trade, banking, and others.

PERSONAL INCOME

Total personal income in the State of California is expected to increase substantially during 1984-85. After increasing 7.1 percent in 1983, total personal income will expand an estimated 11.3 percent in 1984 and 9.8 percent in 1985. While the 1983 growth was due to a combination of increases in hourly earnings, hours worked per week, and number of people employed, the expected growth for 1984-85 will be primarily due to the large increase in employment. Nevertheless, wages and salaries per employee are expected to continue to increase throughout 1984 and 1985, but the real gains in wages and salaries per employee will be substantially less than that achieved in 1983. In 1983, wages and salaries per employee grew 4.9 percentage points greater than the consumer price index. In 1984 and 1985, this difference is projected to be 0.9 and 0.6 percentage points, respectively.

CALIFORNIA EMPLOYMENT, 1983-1985

(Thousands)

	1983A	1984F	1985F	Annual Growth Rates		
				1982-83	1983-84	1984-85
Civilian Labor Force	12,332	12,543	12,985	1.2	1.7	3.5
Total Civilian Employment	11,140	11,621	12,084	1.5	4.3	4.0
Unemployment	1,192	921	901	-1.6	-22.7	-2.2
As % of Labor Force	9.7	7.3	6.9	—	—	—
Nonagricultural Wage & Salary Workers	9,927	10,428	10,856	1.0	5.0	4.1
Mining	47	48	50	-6.0	2.3	4.0
Construction	359	408	434	2.8	13.6	6.3
Manufacturing	1,926	2,022	2,098	-0.9	4.9	3.7
Nondurable Goods	620	647	671	-1.2	4.3	3.7
Durable Goods	1,308	1,376	1,428	-0.8	5.2	3.8
Aerospace	660	693	730	1.8	5.0	5.3
Transportation & Public Utilities	535	527	545	-1.5	-1.5	3.4
Trade	2,328	2,507	2,635	2.3	7.7	5.1
Finance, Insurance, & Real Estate	656	691	722	2.1	5.3	4.5
Services	2,350	2,483	2,603	2.9	5.7	4.8
Government	1,725	1,741	1,769	-0.6	0.9	1.6
Federal	327	332	339	-0.1	1.6	1.9
State & Local	1,398	1,409	1,431	-0.7	0.8	1.5

A = Actual F = Forecast

POPULATION AND PERSONAL INCOME

	1983A	1984F	1985F
Population (Thousands)	25,400P	25,900	26,500
Net Migration (Thousands)	273P	264	252
Personal Income (\$ Billions)	333.0	370.6	407.0
Per Capita Personal Income (\$)	13,110	14,309	15,358
Disposable Personal Income (\$ Billions)	284.4	317.8	348.6
1972 Dollars	129.5	140.2	148.0
Annual Rates of Change:			
Population	2.4	2.0	2.3
Net Migration	3.8	-3.3	-4.6
Personal Income	7.1	11.3	9.8
Per Capita	4.5	9.2	7.3
Disposable Personal Income	8.4	11.8	9.7
1972 Dollars	4.3	8.2	5.6

A = Actual F = Forecast P = Preliminary

Another element that is expected to contribute to the rapid growth in total personal income in 1984-85 is the large increase in property income. Although property income increased only 2.2 percent in 1983, it will expand by an estimated 14.4 percent in 1984 and 12.0 percent in 1985. It is likely that the increase in property income will result from both an increase in the stock of rental units and increases in rents. The expanding economy allows rent increases to be instituted at a greater rate, which in turn combines with an improving business environment to encourage investment in rental housing. The increase in nonfarm proprietors' income that occurred in 1983 is expected to continue throughout 1984, contributing to the expected increase in total personal income. However, both farm and nonfarm proprietors' income is expected to remain relatively constant during 1985. The rapid growth of proprietors' income in 1983-84 can be explained by the surge in retail sales during these two years. While it is expected that retail sales will continue to increase in 1985, this will occur at a slower rate and will have a slighter effect on increasing proprietors' income.

The strength of retail sales in 1984 is closely related to the expected growth in disposable personal income. After correcting for inflation, disposable personal income is expected to grow at annual rates greater than the 4.3 percent observed in 1983. The projections are 8.2 percent for 1984 and 5.6 percent for the following year. Furthermore, California's per capita personal income will approximately equal \$15,350 in 1985, which represents an increase of over \$1,000 above the 1984 figure, and approximately \$2,100 above California's per capita personal income in 1983. In 1985 California's per capita personal income will exceed the nation as a whole by approximately \$1,845.

CONSUMER PRICE TRENDS

From 1981 through 1983 the record on California consumer price inflation has been very impressive. Following 1980's sharp rise of 15.6 percent, the increases in consumer prices for 1981 and 1982 were 10.8 and 6.6 percent, respectively. Indeed, prices actually declined at nearly a 5 percent annual rate in the fourth quarter of 1982 and by 0.5 percent in the first quarter of 1983. For 1983 as a whole, California consumer prices rose only 1.6 percent, well below the 3.2 percent pace registered for the nation. Beginning in 1984 and continuing through at least 1985, the California consumer price index will be under greater pressure. It is presently projected that California's consumer price index will average gains of about 4.5 percent for both years. Those increases will be roughly parallel to, if not slightly less than, the increases projected for the nation as a whole.

One of the primary reasons for the more rapid gains in consumer prices over the 1984-85 timespan will be housing costs. In particular, renter's costs and homeowner's costs will rise quite rapidly, as will prices for residential fuel and utilities. Secondly, transportation costs will be boosted by both higher interest rates and by prices for automobiles, both new and used. Price increases for public transportation, on the other hand, will be very modest as will motor fuel and motor oil increases. Indeed, through 1984 and early 1985 it is likely that gasoline prices will be depressed.

Surprisingly, costs for medical care and medical care services have not risen as rapidly as anticipated during 1984. There has been great pressure, both internally and externally, on the medical care industry to contain cost increases, and there is mounting evidence that there has been some success. In addition to medical care, consumer prices for food and beverages, particularly food at home have not been rising very rapidly compared with earlier expectations. The 1984 harvest was, for the most part, better than anticipated and production costs did not rise appreciably compared with earlier years.

Two additional index items, apparel and upkeep, and energy — excluding motor oil, coolant and other products — have had a great influence on consumer price trends during 1984 as declining prices for both of these items have helped to hold down the overall index. If, for example, energy prices were eliminated from the overall index it would be roughly one percent higher than forecast for 1984.

CONSUMER SPENDING

Due to the strength in California's residential construction activity in late 1982, 1983, and the first quarter of 1984, sales of housing-related goods led a strong advance in taxable sales growth in 1983 and 1984. In addition, the nationwide recovery in automobile sales is very evident in California, where sales of new motor vehicles will exceed an estimated \$20 billion in 1984, a 57 percent increase over 1982. New motor vehicle sales are expected to continue to increase into 1985 at a moderated rate.

Total taxable sales are expected to increase from \$169.1 billion in 1983 to \$191.1 billion in 1984 and \$208.4 billion in 1985. After adjusting for inflation, this reflects an annual increase of 11.3 percent for 1984 and 5.3 percent for 1985. The first two quarters of both these years are expected to demonstrate particularly strong increases in sales, and this is true for most categories of sales as well as total taxable sales. For example, real taxable sales of new motor vehicles were very strong in the first two quarters of 1984 as sales increased at an annual rate near 30 percent. However, sales will grow only marginally in the third quarter before increasing above an annual rate of ten percent for both the fourth quarter of 1984 and the first quarter of 1985. For the remainder of 1985, real taxable sales of new motor vehicles are expected to remain nearly constant. Sales of housing-related goods will also follow this trend very closely.

GROSS STATE PRODUCT TAXABLE SALES AND PRICES

	1983A	1984F	1985F
Gross State Product (\$ Billions)	402.0	452.2	495.9
1972 Dollars	181.4	196.8	207.3
Taxable Sales (\$ Billions)	169.1	191.9	208.4
Consumer Price Index	299.4	312.5	326.7
Annual Rates of Change:			
Gross State Product	8.5	12.5	9.7
1972 Dollars	4.1	8.5	5.3
Taxable Sales	9.4	13.5	8.6
Consumer Prices	1.6	4.4	4.5

A = Actual

F = Forecast

The above trends reflect interest rate movements and expectations. As mortgage rates fell from their 1981 peak, residential construction activity picked up, and this could explain the advance in building material sales and household appliance and furnishing sales. It is also conceivable that large appliance purchases and new motor vehicle purchases were very strong in 1983-84 because purchases were postponed in 1981-82 by cautious consumers, while other consumers may be accelerating purchases planned after 1984 due to expectations of rising interest rates. Other retail sales categories are less dependent upon interest rate fluctuations; consequently, the fluctuations observed in new motor vehicle and housing-related product sales are moderated considerably for all other categories. Food, liquor, and restaurant sales are expected to continue to accelerate into 1985, with real taxable sales increasing 4.7 percent in 1984 and 5.8 percent in 1985. Taxable sales at apparel and general merchandise stores will increase approximately \$3 billion between 1983 and 1984, and nearly \$2 billion for 1985. Thus, while the increase of sales in this category is expected to moderate in 1985, it does not demonstrate the degree of break expected in the rate of increase of sales of new motor vehicles and housing-related products. ■

CALIFORNIA INDUSTRY TRENDS

AEROSPACE/HIGH TECHNOLOGY

One of the fastest growing and most publicized segments of the economy in recent years has been the high-tech industry. The high-tech industry is actually a combination of many separate industries with certain similar operating characteristics. Though there is no unanimous definition of high tech, two characteristics are generally believed to identify high-tech industries: a relatively high ratio of research and development expense to sales, and approximately 10 percent of the workforce employed in natural science, technical, or engineering occupations. Using this standard, the high-tech industry includes the makers of computers, communications equipment, electronics, aircraft, missiles, office machines, and space vehicles. High-tech industries are extremely competitive and subject to rapid change which can produce tremendous growth or dramatic losses.

Since the beginning of the technological revolution, California has proven to be fertile ground for high-tech industries. Originally drawn to California because of its excellent technical universities and moderate climate, the high-tech industry represents a significant contribution to the state's economy. In terms of wage and salary employment, the high-tech sector provides approximately one third of all manufacturing jobs in the state.

After recording substantial growth rates between 1977 and 1980, California's high-technology industries experienced slower growth through 1983. Total employment in California's high-tech industries increased 166,700 between 1977 and 1980, but increased only 37,100 in the following three years. This large difference is not due to a general slowdown in all high-tech industries, because the communications equipment, guided missiles, and space vehicles industries continued to expand at rapid rates. Rather, it was the relative stagnation of the office computing machines and electronics industries — combined with a steady decline in employment in the aircraft industry — that caused the slower growth in high-tech

employment. Many of the reasons for the slowdown of growth in these latter three industries are no longer concerns in 1984.

With the improving economy, both consumers and businesses have increased airline travel and computer equipment purchases, resulting in additional sales for the three industries. As interest rates fell from their 1981 peak, the environment for capital investments greatly improved. However, their recent climb has somewhat offset this improved investment atmosphere, and future rate movements may prove to be very crucial to the commercial aircraft and computer industries.

In addition, the strengthening of the U.S. dollar continues to be of some concern, for it increases the cost of American goods to foreign nations; however, despite growing competition from Japan and West Germany, the American high-tech industry continues to do very well in international trade. In 1983, an improvement in the United States aerospace trade surplus occurred despite weak commercial aircraft exports and declining military exports. The increasing surplus is largely due to the sharp decline in U.S. aerospace imports, which declined \$1.1 billion in 1983. Given the fact that this occurred with a strong U.S. dollar, it is likely that the U.S. will maintain strong aerospace exports, with increases in military aircraft exports providing the driving force.

Foreign competition in electronics provides more cause for concern, for Japanese firms have proven to be very strong competitors in the production of electronic consumer goods and semiconductors. Furthermore, many U.S. firms have recently relocated assembly plants to nations with lower labor costs, and this may continue to be a major consideration for California's electronics firms since the region's high cost of living requires relatively high labor compensation. Fortunately, demand in the semiconductor market is so strong that Japan's increased market share will not prevent impressive U.S. sales gains in 1984 and 1985. However, many analysts warn that a glut may exist as

early as 1986 if firms rush to expand capacity to meet this demand. Nevertheless, the shortrun outlook for California's semiconductor producers — the major producers in the nation — looks strong. In 1982, nearly 38 percent of all U.S. semiconductor production occurred in Southern California and Santa Clara County alone.

Most of the conditions which caused slow growth in the high-tech industry between 1980 and 1983 should not prevent healthy gains through 1985. Employment in this industry is expected to increase 5.0 percent in 1984 and 5.3 percent in 1985, up significantly from the 1.8 percent increase of 1983. Much of the expected increase in employment will occur in the aircraft industry. Under the military buildup of the Reagan Administration, weapons procurement is the fastest growing part of a quickly growing defense budget. Defense purchases of aircraft should prove to be very strong in 1984-85 as weapons procurement begins an increase which is expected to total 61 percent between 1983 and 1987.

In 1983, approximately 22 percent of the total U.S. military budget was channeled into California; however, this figure should increase as expenditures on weapons accelerate, for California is involved in almost all military hardware and aviation projects. As a result, California's aerospace industry should see increased production of jet fighters, transports, attack helicopters, and guided missiles. The B1 and Stealth bomber programs should also continue to add to California's aerospace employment.

Increased defense spending not only increases employment directly, but also serves a vital role in California's aerospace industry by providing for advancements in production techniques. With upgraded manufacturing facilities, California's firms should be able to produce civilian aircraft more efficiently, improving their position in national and international markets. This may prove very important as the revival of commercial aircraft sales continues. This revival has come about because increasing personal income and business profits are resulting in an increase in recreational and business air travel. In addition, the decline in fuel prices has substantially reduced airline business costs, which has placed many firms in the financial position to modernize their fleet.

Many other conditions indicate that aircraft purchases will be strong. Federal noise regulations are set to be initiated in 1985, giving the airlines additional incentive to replace their aging aircraft. Deregulation has changed the structure of the industry such that wide-body planes are less desirable, and increased price competition is forcing airlines to standardize their fleets in order to increase efficiency. Therefore, it is very likely that sales of new aircraft — especially smaller, fuel efficient planes — will increase substantially in 1984-85. This increase in sales is expected to boost production of economically more efficient planes. Since McDonald Douglas, one of the two major commercial aircraft producers (the other is Boeing Co.), is based in California, a surge in aircraft production is bound to have a positive effect on the State's employment situation. Recent purchases of the Douglas MD-82 by American Airlines point toward that situation. Its production has been steadily increasing and it is likely that production will continue at full scale throughout this decade. The continued success of this aircraft will certainly support the growth of California's aerospace industry.

California continues to benefit from the Space Shuttle and other NASA programs. The recipient of approximately 37 percent of the NASA budget, California's high-tech industry should continue to gain employment as the Space Shuttle reaches new frontiers in commercial space activities. NASA has requested \$150 million in 1985 for preliminary funding of a permanent orbiting space station, a program that will hopefully add to California's aerospace strength. The growth in the NASA and Department of Defense budgets will also have important implications for California's communications equipment industry. Demand for goods such as radar, sonar, and surveillance systems is expected to exceed the industry's capacity, and thus this industry should prove to have significant employment growth. This is just another indication of the important role the government budget plays in the health of the California aerospace industry. Currently, the script calls for increased military spending to lead an overall advance in the aerospace industry, with employment increasing by approximately 70,000 persons in 1984 and 1985, combined.

BANKING

The California banking industry began to see the results of the state's economic recovery during 1983 as credit demands for most major categories of lending accelerated as the year progressed. Importantly, the quality of credit improved dramatically during the course of the year as commercial and industrial lending took more of the form of borrowing for capital improvements and expansion rather than inventory and receivable financing. Likewise, consumer borrowing shifted from dissaving to financing of consumer durables and for real estate and other long-term purchases.

On the deposit side, California banks experienced a tremendous shift in the composition of deposits as deregulation of the financial industry came into full swing. Of special importance was the introduction of money market deposit accounts in December of 1982, and Super-NOW accounts in January of 1983. Moreover, in October of 1983, all new time deposits with original maturities greater than 31 days were deregulated. Finally the banking industry could compete with non-bank entities such as money market funds on a more level playing field and the flow of deposits swung definitely in favor of the banking industry.

For 1984 the strength in California commercial bank lending is expected to show sharp gains in all major categories. Gross loans will expand by over 8 percent, led by an increase of nearly 13 percent in commercial and industrial loans and a gain of almost 14 percent in consumer loans. Real estate loans will expand a more modest, but still impressive, 5.7 percent. Slower economic growth in the latter months of 1984, and through 1985, will tend to reduce 1985 growth rates for all major loan types, although the reduction in growth rates will be relatively modest. For example, after moving up an anticipated 8.9 percent in 1984, gross loans are projected to increase 7.7 percent in 1985.

Total deposit growth is also expected to slow in 1985 compared with 1984, from 7.9 to 5.8 percent. The slower pace of consumer spending in 1985 should lead to a slight reduction in transaction balances growth. At the same time, personal income gains in the state will be less rapid and rising debt burdens will cause a shift from increased saving toward greater debt repayment requirements. On balance, the state's commercial banking industry should fare well during both 1984 and 1985 despite the overhang of credit difficulties that will persist for some time on both a state and national scale.

CALIFORNIA BANKING FORECAST (Outstandings, End of Year)

	1983A	1984F	1985F	Annual Growth Rates		
				1982-83	1983-84	1984-85
Gross Loans* (\$ Billions)	147.9	161.0	173.4	3.5	8.9	7.7
Commercial & Industrial	48.8	55.0	61.6	5.4	12.7	12.0
Real Estate	54.4	57.5	59.9	1.3	5.7	4.1
Consumer	23.9	27.2	30.2	8.6	13.8	11.0
All Other	20.8	21.3	21.7	-0.5	2.4	1.9
Total Deposits (\$ Billions)	178.8	192.9	204.1	8.2	7.9	5.8
Demand	45.5	46.4	47.3	12.4	2.0	1.9
Time & Savings	133.3	146.5	156.8	6.9	9.9	7.0
Loan-To-Deposit Ratio (%)	82.7	83.0	85.0			

*Minus loans to domestic commercial banks
A = Actual F = Forecast

CONSTRUCTION OUTLOOK

The California construction industry can only be characterized as having experienced a booming recovery from the doldrums of 1982. During 1983, for example, total valuations for building permits authorizing construction in the state exceeded the depressed 1982 figure by nearly 44 percent. That figure represents an increase in dollar volume of \$6.9 billion, to a 1983 total of \$21.4 billion. Although the gain for 1984 will be less, just over 18 percent, the total dollar volume of building permits for that year will exceed \$25 billion. During the second half of 1984 and throughout 1985, however, several forces will be emerging to cool the robust growth of the state's construction industry.

It is presently forecast that the California economy will begin to register some easing in business activity starting in the second half of 1984, as rising interest rates tend to dull both business and consumer spending. Similarly, the state's construction industry, both residential and nonresidential, will feel the pinch. That slowing trend was already in evidence during the third quarter, and is expected to accelerate through the forecast period. In addition to the general slowing in

economic activity, the interest-rate sensitive building industry has been one of the first to show concern about inventory levels, as increasing numbers of residential buyers are reacting to higher interest rates and as nonresidential vacancy rates edge higher.

Of great concern to residential builders is the slowing in traffic at finished and nearly completed projects. A number of residential builders in California began to adjust building plans early in the second half of 1984 as potential buyers either stayed away, or voiced great concern over the threatened rise in mortgage interest rates. It is generally calculated that a one percent rise in mortgage interest rates, say from 13 to 14 percent, would have a substantial impact on the ability of many buyers to meet their monthly installments. On a typical home in California, priced at \$110,000, a buyer would have to come up with some \$70 more in monthly payments, and would have to see a rise in annual income of about \$2,700 to qualify for the standard 80 percent conventional loan.

CALIFORNIA CONSTRUCTION FORECAST

	Annual Growth Rates					
	1983A	1984F	1985F	1982-83	1983-84	1984-85
New Housing Permits (000)	168.4	194.8	151.1	100.0	15.7	-22.4
Single Units	99.3	103.7	80.6	99.4	4.4	-22.3
Multiple Units	69.1	91.1	70.5	100.9	31.8	-22.6
Total Valuation (\$ Million)	21,421	25,317	24,662	43.7	18.2	-2.6
Residential	11,511	14,170	12,325	86.3	23.1	-13.0
Single Units	7,160	8,044	6,428	107.7	12.4	-20.1
Multiple Units	2,858	4,329	3,669	92.0	51.5	-15.3
Alterations	1,493	1,797	2,228	20.1	20.4	24.0
Nonresidential	9,910	11,148	12,337	13.5	12.5	10.7
Commercial	4,457	5,500	6,186	6.7	23.4	12.5
Industrial	1,313	1,543	1,701	24.8	17.5	10.2
Alterations	2,663	2,676	2,970	26.8	0.5	11.0
Other	1,478	1,409	1,480	5.5	-4.7	5.0

Note: Beginning with data for 1980, permits for nonresidential alterations and additions valued at \$100,000 and over are no longer classified as new construction, resulting in lower totals for commercial, industrial, and other construction and higher totals for nonresidential alterations/additions. Consequently, only total nonresidential valuations are strictly comparable with past data.

A = Actual F = Forecast

Security Pacific Bank's mortgage interest rate assumptions call for an increasing trend through the end of 1985. While the rise in commitment rates for long-term, fixed-rate loans is expected to be a relatively modest 150 basis points (1.5 percentage points) between August, 1984 and December, 1985, even an increase of that magnitude has the potential effectively to eliminate thousands of would be buyers as mortgage rates hover in the 16 percent range. In reaction to the likelihood of easing housing market strength, residential construction is projected to trend downward from the third quarter of 1984 through the end of the following year. Based upon that assumption, residential construction activity, as measured by building permits authorizing new units, will decline from 1984's level of 195 thousand to a 1985 level of 151 thousand units. And, the valuation of new residential building will fall an estimated \$1.9 billion in 1985 from the prior year's level, for a 1985 total of \$12.3 billion.

The trend in California home price appreciation will be favorably influenced from the buyer's viewpoint by the weakened housing market, as home prices rise in the 4.5 to 5.0 percent neighborhood during both 1984 and 1985. During the preceding two years the price of a new home in the state increased at an average rate of roughly 5.5 to 6.0 percent. Regrettably, even though home prices will be rising less rapidly during 1984-85 than for the prior two years, concurrent with substantial gains in real disposable personal income, interest rate trends will be working against buyers to the extent that little real benefit will be recognized. As a result, the problems faced by buyers, particularly first-time buyers, will not likely be diminished.

Nonresidential construction activity, unlike residential, is forecast to register diminishing growth rates during the latter months of 1984 and through most of 1985, rather than an actual decline in the valuation of construction authorized. New commercial construction, with an estimated value of \$5.5 billion for 1984, is projected to record a gain of nearly 13 percent in 1985, 7 percent in inflation-adjusted terms. Those increases compare with very strong 1984 gains of 25 percent in nominal terms and 23 percent in inflation-adjusted terms. New commercial construction, the largest of the nonresidential categories, has shown surprising strength in the face of relatively high vacancy rates in most metropolitan areas. For example, as of June, 1984, Coldwell-Banker reported that the following office vacancy rates were registered for downtown

areas: Sacramento (23%), San Diego (17.4%), Los Angeles (11.8%), and San Francisco (8.6 %). Moreover, suburban office vacancy rates for those areas were considerably higher: Sacramento (28%), San Francisco (21%), Los Angeles (17.6%), and San Diego (15.9%).

New industrial construction in California is expected to mirror the trend in new commercial construction during both 1984 and 1985; in terms of growth rates both categories will be easing but will still be recording some growth. Indeed, even after adjusting for inflation, the value of new industrial building authorized for construction in the state will show a 1984 increase of 18 percent, followed in 1985 by a 5 percent gain. The nominal value of new industrial permit authorizations is expected to increase from a 1984 total of \$1.5 billion to \$1.7 billion in the subsequent year.

Alterations and additions to existing nonresidential structures, the second largest of the nonresidential categories in dollar terms, is forecast to show virtually no growth during 1984 and to show moderate gains in 1985. This category showed exceptional expansion in 1983, gaining some 28 percent in inflation-adjusted terms. The "other" category of nonresidential building, which includes churches, schools, etc., is the smallest — in dollar terms — of the four types. Other nonresidential building is projected to fall 6 percent in 1984 and remain flat in 1985, after adjusting for inflation.

INTERNATIONAL TRADE Overview

California's international trade is experiencing a mild turnaround from the recent slowing of trade growth and widening of the trade deficit. While a strong dollar has resulted in imports growing faster than exports in the past, the anticipated decline in the dollar's value should help to spur exports thereby lessening the gap between imports and exports. Total trade between California and its trading partners registered \$67.3 billion in 1983. Which is a 9 percent increase over the previous year. First quarter 1984 trade for California hit \$19.9 billion which is \$4.0 billion above first quarter 1983.

The trade pattern in California has shifted towards the Pacific Rim as California has proven to be a major gateway to the Far East. The economic climate in Asia is becoming more favorable, especially as the Sino-American relationship solidifies. The first quarter 1984 figures already show an export increase of 34 percent to the Asian region. Additionally, as China looks to the U.S. for capital, technology and equipment to improve their economic infrastructure, California's exports will increase.

The proximity of Asia accounts for the abundant trade flows relative to other world areas. Japan is California's single largest trading partner with total two way trade amounting to \$21.9 billion in 1983. Imports alone topped \$15 billion which is 40 percent of all California imports. Exports to Japan reached nearly \$7 billion — 2 percent more than was exported to all of Europe. As the yen gains strength relative to the dollar, more of California's exports are expected to enter Japan. An increase in purchasing power will give rise to increased demand for California's agricultural products such as fruits, nuts, vegetables and meats. Also, demand for cotton will increase as personal incomes in both the developed and developing nations in Asia rise over the business cycle.

CALIFORNIA'S LEADING TRADING PARTNERS, 1983 (\$ Billions)

	Imports	Exports	Total
1. Japan	15.0	6.9	21.9
2. Canada*	2.8	2.7	5.5
3. Taiwan	3.9	1.6	5.5
4. South Korea	2.6	2.7	5.3
5. Singapore	1.2	2.0	3.2
6. Hong Kong	1.9	1.3	3.2
7. West Germany	1.6	1.0	2.6
8. Australia	.4	2.1	2.5
9. Malaysia	1.1	1.2	2.3
10. Mexico	1.1	1.1	2.2

Source: U.S. Department of Commerce; Security Pacific International Trade Databank.

*Canada's trade figures provided by Canadian Consulate General.

California's personal income growth is expected to rise through 1985 along with employment. The projected income growth for the state is 1 to 2 percentage points greater than the expected growth for the nation. This strong nominal income growth should sustain the growth of imports into the state, especially imports of consumer products, which comprise a large share of California's total import bill.

Imports have exceeded exports at an increasing rate in the last several years. Total commodity imports for California in 1983 stood at \$37.9 billion, \$8.5 billion over exports. Although this deficit appears large, it is important to remember that a unique reporting basis exists because of flow through commodities. For example, Canada is California's second largest trading partner. However, most Canadian commodities destined for California enter the U.S. through a northern U.S. custom district. Thus, the Canada-California trade statistics tend to downplay the actual size of trade between these two areas. Officially, total two way trade in 1983 was \$5.5 billion of which California's total sales to Canada totaled \$2.7 billion. Additionally, services are not reported in the deficit calculation which would tend to reduce the deficit because of the surplus of service exports over imports.

Exports

California's dominant export commodity group, which totaled over \$6.4 billion in 1983, consisted of machinery and mechanical equipment, composed primarily of automatic data processing equipment and office machinery. California's high tech products perform well as exports and include semiconductors, radio/television transmitting equipment, telephone and telegraph equipment and navigational equipment. Exports of these products topped \$5.3 billion in 1983. The aerospace industry is also an important source of exports. Aircraft parts and missiles exports exceeded \$2 billion in 1983. The state also has a \$2 billion plus export level of medical instrumentation and photographic equipment, including sophisticated microscopes, measuring and controlling instruments, and motion picture cameras.

Additionally, agriculture accounts for a substantial portion of exports. Among agricultural products, cotton exports reached \$1.3 billion in 1983 and shipment of fruits and nuts totalled nearly \$750 million. Cereal grains, vegetables, meats and animal hides were all significant export items in 1983. Petroleum is also a major export good, with \$1.1 billion in crude oil shipped abroad in 1983.

CALIFORNIA'S PRINCIPAL EXPORTS (\$ Billions)

	1983	1st Quarter 1984
1. Machinery and Mechanical Equipment	\$6.4	\$1.7
2. Electrical Machinery and Equipment	5.3	1.4
3. Agricultural Products	3.0	.9
4. Aircraft and Spacecraft	2.3	.5
5. Optical and Scientific Equipment	2.2	.6
6. Petroleum	1.3	.2

Sources: U.S. Department of Commerce; Security Pacific Bank's International Trade Databank.

Imports

In contrast to the predominantly capital goods and natural resource exports, imports are composed primarily of consumer oriented goods. Radio, television, and other consumer electronics comprise the largest category of imported products with over \$9.2 billion in 1983. The second largest import group is automobiles with over \$5.6 billion in imports. Other significant consumer oriented imports are wearing apparel and accessories (\$1.96 billion in 1983),

CALIFORNIA'S PRINCIPAL IMPORTS (\$ Billions)

	1983	1st Quarter 1984
1. Electrical Machinery and Equipment	\$9.2	\$3.2
2. Motor Vehicles	5.6	1.5
3. Machinery and Mechanical Equipment	5.4	2.2
4. Wearing Apparel	2.0	.6
5. Petroleum and Natural Gas	1.8	.4
6. Optical, Scientific Instruments and Photographic Equipment	1.5	.5

Sources: U.S. Department of Commerce; Security Pacific Bank's International Trade Databank.

firearms, sporting goods, toys, and bicycles (\$1.03 billion) and shoes, hats, gloves, and luggage (\$894 million). Despite the abundant consumer oriented imports, a significant amount of finished capital goods enter California's ports from abroad. This includes automated data processing equipment, office machines, finished metal products, and electronic components. Some high tech "raw materials" such as semiconductors are also important. Finally, refined petroleum products such as gasoline and jet fuel are also a significant import good, amounting to \$1.85 billion in imports in 1983.

Customs Districts

California has three customs districts, with Los Angeles the largest in the state and the second largest in the nation. Total trade through the Los Angeles port for 1983 reached \$42.5 billion, up 10 percent from the previous year. Over 63 percent of the state's imports and exports pass through the Los Angeles custom district, and over 40 percent of all West Coast trade enters or exits via Los Angeles. The share of the states exports shipped through the Los Angeles district is less than its share of imports, but it is still the largest point of departure, with over 58 percent of the state's total export value sent through Los Angeles.

By contrast, San Francisco has a larger share of exports than imports passing through its ports. This is explained by the fact that San Francisco is close to the state's largest agricultural areas, and exports of these products traditionally exceed imports. Approximately one third of California's total international trade passes through the San Francisco customs district.

San Diego accounts for the smallest volume of California's trade. Only about three percent of the state's total international transactions involve the San Diego customs district and its major trading partner is, naturally, Mexico. Over 90 percent of the district's exports are sent to Mexico, while imports register almost 85 percent.

Outlook

While California's international trade closely follows the national pattern, exports should strengthen as a result of the anticipated slight fall in the value of the U.S. dollar relative to other major currencies. Although imports are also expected to increase resulting from higher personal incomes, the increased exports should help to narrow California's deficit. These changes in trade patterns, especially those resulting from currency movements, usually take months to develop. Nonetheless, the outlook for California's international trade looks very favorable.

CALIFORNIA AGRICULTURE

Much of California's agricultural industry has seen improved production, better commodity prices, and lower production costs. However, this is overshadowed by the agricultural sectors that are burdened with persistent high interest costs and low commodity prices. Such problems will cause significant changes in the structure of troubled sectors of the industry.

Cash receipts for California's agricultural production fell for the first time since 1975, dropping from \$14.3 billion in 1982 to \$13 billion in 1983. This decrease was primarily due to reduced production, a result of both adverse weather conditions and acreage being set aside from production.

Last year's persistent rain delayed the planting of many crops which reduced yields in many instances. The late crops coupled with early fall rain caused difficulties during harvest. This was especially a problem with field crops such as cotton and processing tomatoes. The extremely wet winter last year caused severe damage to tree fruit yields and significantly permanent damage to many orchards.

In 1983, approximately 1.6 million acres were set aside from production as a result of the government's Payment In Kind (PIK) program. In hopes of bolstering commodity prices for cotton, rice, and grains the PIK

program was designed to reduce burdensome inventories of such commodities. PIK gave growers title to surplus commodities in exchange for reduction in their production of the same crops. There was much more participation in the PIK program than the government expected. In fact, last year the USDA had to entice cotton growers into the government loan program just to have sufficient commodity supplies to fulfill PIK obligations. The acreage reductions in combination with weather reduced yields throughout the country and sharply improved prices.

Similar to the overall inflation rate, the increased cost of production for California growers was moderate. Energy related costs were stable, and in fact, farmers and ranchers benefited from actual decreases in the price of gasoline and diesel fuel during 1983. Labor costs were also unchanged. Many workers were underemployed because of the reduced levels of production. While real interest rates remained high, the average cost of borrowing money was significantly less than during the two preceding years.

At the beginning of the 1970s, a mere 15 percent of California's agricultural production was exported to foreign markets. By the 1980s, this figure had increased to approximately 25 percent. The California ag sector's increased dependence on export markets has made it more vulnerable to the recent weakness in U.S. export activity. The export value of California farm products was \$3.0 billion last year. This contrasts with \$3.3 billion in 1982 and a high of \$4.2 billion in 1981. The strong value of the U.S. dollar has made California's agricultural products more expensive to foreign buyers, and many importing nations' economies have been weak.

Despite the decrease in total cash receipts of California agriculture last year, net income was bolstered by improved commodity prices and lower production costs. Additionally, the income generated by the sale of PIK entitlements contributed to net income. Some of this income may be realized this year because farmers did not sell all of the PIK entitlements in 1983.

This year's precipitation has been less than normal, but in combination with stored water from last year, water supplies are adequate. More importantly, the relatively dry weather this year has allowed more normal planting and crop set. There have been periods of extremely hot temperatures which have quickened the maturity of many fruits, flooding the markets with large volumes of smaller fruit. Vegetable growers have had similar problems with hot weather.

Many markets have been good for California growers. The local orange industry has benefited from the frost damage to Florida's oranges and orange trees. Prices for strawberries were strong this year, and the table grape crop was early and enjoyed good quality and prices. While erratic, cotton prices have been higher than levels seen prior to the PIK program. Some fruit growers, such as growers of pears and cling peaches, have experienced better prices because inventories were depleted by last year's weather induced losses.

Yet, many growers are faced with sluggish market prices because of weak export demand and over-supplied markets. Three particularly troublesome sectors are Thompson Seedless Grapes for raisins or wine, dairies, and deciduous fruits such as peaches, plums, and nectarines.

The markets for wine and raisins failed to grow as quickly as production. This has been especially burdensome for growers of Thompson Seedless Grapes that usually go to wine or raisins. Producing acreage has increased sharply, foreign markets have been weak because of the strength of the U.S. dollar and greater foreign raisin production, and wineries have less need for bulk wine grapes such as the Thompsons. Many grape growers have seen "red ink" for the last few years, and this year is not promising. Many marginal producing vineyards will be pulled in light of the poor prospects for immediate improvements.

While the long downward trend in the consumption of milk and milk products appears to have stabilized, price prospects are still poor. The government's new program to pay dairies to reduce their production has succeeded to a limited extent, however surplus production remains. It is probable that the government support level of the dairy industry will be decreased in the 1985 farm bill. Fortunately, many dairies are presently taking advantage of the opportunity to reduce

operations. However, some dairies may prove to be noncompetitive either because they have depended upon surplus purchases by the government or because of excessive debt loads. The California dairy industry is increasing its efforts to market milk products as demonstrated by the new California cheese promotional campaign.

Many fruit growers, such as those of peaches, plums and nectarines, have been hit hard by poor prices and higher production costs this year. Extremely large crop sets necessitated expensive thinning and in some instances, caused tree damage. The hurried harvest and small fruit size has resulted in poor returns.

Reflecting the declining profitability since 1980, California agricultural real estate has significantly depreciated. The industry is accustomed to sharp fluctuations in earnings, but the long-term weakness and the poor prospects for immediate improvement have depressed the sales of agricultural real estate. Sales have been infrequent despite numerous listings. Financing for completed sales has also been difficult. Most completed sales include some type of seller financing.

In addition to the poor earnings on much of the real estate, its value has been impacted by the decline in the rate of inflation. Many investors, including growers, purchased agricultural real estate as a hedge against inflation during the seventies. Now that inflation has moderated, many investors fear that agricultural real estate is overvalued.

This is particularly troublesome for lenders. The value of the collateral is in jeopardy for real estate lenders. Additionally, short-term production lenders that depend upon equity in real estate are concerned about the capacity of some troubled agricultural operators to service previous loans, let alone new credit.

However, not all agricultural real estate values have depreciated. Near the Coast, vegetable acreage, strawberry acreage, and orange orchards have sold at high values. This is the result of their better earnings record.

Burdensome surplus production, weak exports, and the high cost of borrowing money threaten structural changes for some sectors of California agriculture. Many growers will find it necessary to retrench and improve their equity positions.

Unfortunately, many ag real estate owners probable feel the pressure of depreciated land values.

Even so, it is unlikely that such land will be taken out of production. Many investors, other growers in most instances, will seize the opportunity to buy land at lower prices. It is likely that such acreage will not be burdened with same high debt load as the previous owner and will have a greater earnings potential given existing commodity prices.

TRAVEL & TOURISM

Consumer caution continues to dominate California's travel and tourism activity — an industry which has been beset by a myriad of problems in the past several years. Business travel has been curtailed as companies seek to control operating costs. Convention bookings — while strong — frequently have produced smaller than anticipated attendance. And in many instances potential vacationers either have been pinched by the higher costs of necessities or they have had other spending priorities (e.g. household durable goods purchases). Adding to the industry's problems is the fact that the high value of the U.S. dollar reduced foreign travel to California and helped draw potential business away from the state to other countries. Overall, in a period when consumers were in a spending mood and most businesses were experiencing strong recovery, the travel business failed to benefit significantly.

Highlighted below are some the recent trends in California's tourism indicators.

- In 1982, the number of trips taken within the state declined 7.4 percent, while travel was expected to ride the waves of an economic recovery in 1983, the number of trips sank another 9.8 percent. And even though gasoline prices at self service stations have dropped more than 20 cents a gallon over the past two years, weekend travel on the state's highways has not changed significantly, advancing at less than 2 percent per year over the last 3 years.
- Data from the CPA firm Pannell Kern Forster indicate a moderate recovery in hotel occupancy rates in 1983 following a three year downtrend. This year, the state's overall occupancy rates should surpass last year's average by 2-3 percent.

- Airlines have been improving their financial positions somewhat by reducing operating costs and by significantly lowering the percentage of passengers traveling on discount tickets — a problem that has plagued major carriers for the past several years. But intense competition from new airlines has severely challenged established carriers and made probable continued periods of fare wars — a factor that stands to lower overall travel industry revenues and profits.

- California's attractions had a mixed year in 1983 with the State Office of Tourism's index of attraction attendance off 17 percent in Northern California and up 4.7 percent in Southern California. After a disappointing first half of 1983, attraction attendance improved in late 1983 and in the beginning months of 1984. Importantly, capital expenditures for the state's attractions have been considerable over the past year as entertainment facilities try to enhance their place in tourist spending priorities.

The travel industry entered 1984 on an uptrend with two major events expected to bolster revenues — the Olympic Games in Southern California and the Democratic National Convention in San Francisco. Overall, however, we expect state tourist revenues to advance 2-3 percent at best for the full year. No final figures are currently available regarding the economic impact of the Olympic Games, but there are indications that while the games were strongly supported by Californians, foreign and out-of-state guests did not provide the anticipated boost to the Southland's economy. Hotels and motels were not full, car rentals were well below projections, and overly enthusiastic estimates of visitor spending on related services and goods were disappointing to many businesses. In addition, the summer months are generally very strong for normal visitor and convention activity and that business was down significantly. Almost all major visitor attractions experienced large declines in attendance, dropping as much as 30 percent below the same period last year. Similarly, in San Francisco, some restaurants and retailers lost business during the Democratic Convention, as local people avoided the area, but some Southern Californians wishing to avoid the Olympics traveled north.

Over the longer-term, the state's visitor industry will probably overcome these recent disappointments. California has increasingly found itself competing for tourism dollars with other areas of the country and the world, with other areas turning to tourism to broaden their economies and in some cases to replace declining industries. The Olympics have provided an unparalleled opportunity to create a renewed interest in California for tourism and large conventions. In addition, the state legislature recently approved \$5 million in expenditures to help California better compete in this new business environment through a major marketing effort.

The increase in U.S. and California personal incomes anticipated for 1985 will likely enhance prospects for the state's tourism businesses. But it should be kept in mind that the income gains of the past few years benefited the visitor industry much less than had been true historically — perhaps a result of higher prices of necessity items combined with increased competition for discretionary dollars by alternative uses (e.g., saving, or other forms of entertainment). The major question still facing this industry is whether over the past few years consumers have been making a fundamental change in their spending priorities and in the way they use leisure time. If true, this would force the industry to evaluate every aspect of its approach to the marketplace. One thing seems clear: competition is up on all fronts and the consumer discretionary dollar has been squeezed by higher costs for necessities. Also, some industry experts see important competition coming from more "home" oriented lifestyles, and

consumers appear to be more sensitive to economic uncertainties and more conservative about some types of spending.

All of this leaves considerable uncertainty surrounding the prospects for 1985 and beyond. Overall, a 4 percent gain in tourism industry revenues is projected for next year, with convention activity to increase and foreign visitor activity to remain weak. ■

THE OUTLOOK FOR CALIFORNIA'S REGIONS

The following articles discuss economic trends and the outlook for the state's three regions — Southern California, Northern Coastal California, and the Central and Mountain counties. The map on this page shows the geographical definitions of those areas.



- ☒ Northern Coastal California
- ☒ Central and Mountain Counties
- ☒ Southern California

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SOUTHERN CALIFORNIA

During the first half of 1984, Southern California's economy benefited from continued strong consumer demand for housing and retail items, rising business spending for plant and equipment, and large real gains in defense spending. The region's housing production reached unexpectedly high levels during the first half of the year — enhancing activity in a variety of related industries — and sales of consumer durable goods registered double-digit rates of growth. Fueling the consumer-related upturn were pent-up demand for interest-sensitive items, improving labor market conditions, and continued moderate rates of inflation. In addition to a strong consumer sector, the figures for the first half of 1984 show that recovery accelerated for the region's industrial construction. That uptrend resulted in part from the importance in Southern California's economy of aerospace and electronics — industries which benefit from increasing defense expenditures and strong business and consumer demand for electronic products.

The outlook through 1985 calls for the consumer durable goods sectors to play a reduced role in the continuing recovery. The upturn in interest rates that occurred during the first half of 1984 is expected to result in a substantial slowing in the Southland's housing activity, along with slower growth in spending for big ticket consumer items. But the region's basic industries should show continued expansion, and growth in employment and income levels should characterize the next 18 months.

Early this year, Southern California's housing unit authorizations reached an annual rate of above 150,000 — the highest level experienced since the late 1970s. Multifamily dwellings accounted for nearly half of the region's housing production during the first half of 1984, as more liberal depreciation allowances and low vacancy rates led to a surge in apartment construction early in the year. The Southland's housing unit authorizations more than double over the first half 1983 total, and house sales registered a significant, albeit smaller, increase. And while higher mortgage rates will likely cause a substantial slowing in the region's housing market over the next 18 months, the increased popularity of adjustable rate mortgages and continued employment and income gains should be mitigating influences. Overall, about 120,000 dwellings are expected to be authorized for construction for all of 1984, trending down to around 90,000 for all of next year. Comparable figures for 1982 and 1983 were 41,000 units and 94,000 units, respectively.

Like the housing industry, Southern California's consumer markets performed well during the first and second quarters. Data for the first quarter show that virtually all types of stores experienced annual sales gains, with some of the most rapid increases registered by durable goods categories — automobiles, home furnishings and appliances, and building materials — sectors that were depressed during the recession. Indications are that the upward momentum of consumer spending remained strong into the summer months. The next 18 months are expected to show continued real growth in retail sales, with spending for nondurable goods and services playing a greater role than was the case during the recovery through mid 1984.

Offsetting the anticipated slowing in the interest-sensitive sectors are generally favorable prospects for Southern California's basic industries. Aerospace and electronics, which account for about one third of manufacturing employment, stands to benefit from increases in both the defense and nondefense sectors. Demand for military aircraft, space vehicles, and missiles is growing at a healthy rate, and commercial aircraft production is increasing after a prolonged period of weakness. Sales are also increasing for the defense-related electronic sectors of navigational equipment, missile guidance systems, and satellite communications equipment. And continued healthy growth is likely for several nondefense categories, such as semiconductors and computer-related items, as advances in both production methods and new applications make these products accessible to a wide scope of markets.

As of late summer 1984, the upturn in consumer spending had not greatly benefited the region's tourist businesses. Indications are that 1984's visitors spending through midsummer was similar to the lackluster levels of the corresponding 1983 period. And with tourist spending for late July to mid August estimated to have been little changed from the like 1983 interval, the Summer Olympic Games proved disappointing to many operators of hotels, restaurants, and visitor attractions. It appears that concern about crowded and expensive facilities, traffic congestion, and air pollution discouraged many would-be visitors from coming to Southern California. Too, a highly valued dollar on foreign exchange markets no doubt limited the number of foreign visitors. Notwithstanding the recent trend, the Olympic Games did provide the region with considerable worldwide exposure, which should help to add to attraction of future visitors.

SELECTED ECONOMIC INDICATORS: SOUTHERN CALIFORNIA

	1976	1977	1978	1979	1980	1981	1982	1983
Growth in Total Wage and Salary Employment (%)*	3.9	5.7	7.4	5.1	1.5	1.6	-2.2	0.6
Real Growth in Taxable Retail Sales (%)**	8.0	12.9	8.0	2.7	-5.2	1.8	-2.9	7.7
Increase in Consumer Price Index (%)	6.6	6.9	7.3	10.8	15.7	9.8	6.0	1.7
Unemployment Rate (%)*	8.8	7.8	6.6	5.5	6.3	6.6	9.2	9.0
Annual Net Migration of Population (000)	122.1	148.6	158.7	148.7	145.1	125.6	133.9	116.3
Annual Housing Unit Authorizations (000)	122.9	153.4	134.9	111.9	77.0	59.2	41.7	94.1

*Based on data for Los Angeles, Orange, Riverside, San Bernardino, San Diego, Santa Barbara and Ventura counties.

**Adjusted for the "commodities less food" component of the Los Angeles - Orange County Consumer Price Index.

Continued mixed trends are expected for two other basic industries — agriculture and international trade. Many Southern California growers have benefited from improved commodity prices and increased production. And while water costs have been on the rise, the costs of many other production inputs are down. Not surprisingly, profitability trends have varied widely among the Southland's farm commodities. For example, table grape and orange growers recently have realized very strong prices, and profits have improved some for dairymen and egg ranchers. On the other hand, the region's cattlemen have been plagued by high feed prices and a shift in consumer preferences away from meat. And while nursery growers have been helped by strong consumer demand, they also face stiff foreign competition.

In the international trade sector, continuation of the U.S. economic recovery should enable further healthy gains in import volumes. And economic expansion by the Southland's key Asian trading partners should provide some relief for beleaguered exporters. But the persistent strength of the U.S. dollar on foreign exchange markets will continue to limit the region's export volumes.

Regarding the employment situation, a major trend of the past two years has been the abrupt fall in the unemployment rate in many areas of the country, including Southern California. The seasonally-adjusted

jobless rate for Southland's six metropolitan areas fell from above 10 percent in early 1983 to a little over 7 percent by mid 1984. Part of this drop resulted from growth in the number of jobs — a trend that accelerated during the first half of this year. But at least as important a factor is the substantial slowing of labor force growth — in the Southland as well as nationally. Between May 1983 and May 1984, the region's labor force increased only 0.6 percent, compared with an averaged annual growth rate of 1.5 percent from 1980 through 1983 and a 3.8 percent yearly rate of growth over the 1972-80 interval. A substantial reduction in the number of young persons entering the job market (owing to lower birth rates beginning in the early 1960s) contributes importantly to the region's slower labor force growth. But continuation of this trend over the long term is difficult to reconcile with Southern California's still rapid population gains. Most likely over the next couple of years is labor force growth of about 1.5-2.0 percent annually — half the growth rate of the 1970s, but well above the current pattern. The region's unemployment rate will likely remain in the 7-8 percent range through the end of next year, as labor force growth accelerates and job gains slow some from early 1984's pace.

While residential building activity is expected to slow through 1985 from early 1984's high levels, the upturn registered so far this year in nonresidential construction could well continue, notwithstanding higher interest rates. The recovery in construction of industrial facilities accelerated during the first half of 1984 (a 50 percent year-to-year increase in permit valuations was

registered), as the economic upturn and bright prospects for aerospace-electronics manufacturers encouraged many firms to expand and upgrade their facilities. These same factors could continue the uptrend in industrial permit valuations through 1985, even though considerable industrial space had already come on line by the middle of this year.

Office permit activity registered healthy gains during the first half of 1984, and data for several of the region's largest office markets show that vacancy rates trended down modestly from the 1983's high levels. And while office permit activity in some areas will be limited by the large amount of completed space already on the market as well as by higher interest rates, bullish long-term investor expectations and a healthy outlook for office employment are factors likely to benefit construction.

CALIFORNIA'S CENTRAL AND MOUNTAIN COUNTIES

The economic outlook for the thirty-three Central and Mountain Counties of California continues to be favorable, with 1984 at least as good a year as 1983 in most respects. The economic expansion which began in late 1982 will be sustained through the end of this year, with little chance of a significant downturn in economic activity in the near term.

One of the most important sources of economic growth for any region is the external demand for the products the region can produce at a comparative advantage to other regions. For most Central and Mountain counties, these include natural resource products ranging from raw agricultural commodities and processed foods to refined petroleum products and lumber. Also, several of the region's more populated urban areas are experiencing some growth in high tech manufacturing activities.

Growth in these major "export" sectors have propelled an increase in regional economic activity. Rising incomes in the area have fueled demand for business and personal services such as finance, insurance, and real estate, as well as retail trade, homebuilding, and government services. Total taxable sales in the region showed substantial gains in the first quarter of 1984 over the same period in 1983. Fresno and Sacramento counties each experienced 19 percent increases during this period, and Kern County posted a 16 percent gain. Over \$3 billion in taxable transactions

occurred in these counties in the first quarter alone, with over \$854 million of this total composed of building materials and automotive goods. This strong trade performance should continue throughout 1984 and well into 1985 as personal incomes and the number of people with jobs expands.

Another indicator of the health of the Central and Mountain economy is the increase in the number of people holding jobs. Total wage and salary employment in the region has increased in each of the past eight months over the comparable month one year earlier (ending in May, the last month for which data are available). Job growth in the region, which lagged the statewide pace during the early part of the recovery, topped the state growth rate in the latest three months. Total wage and salary employment in the region in May 1984 was six percent greater than in May 1983.

Despite this steady growth in employment, the unemployment rate in many Central and Mountain counties has remained significantly above the statewide average. The state's unemployment rate fell from a peak of nearly 12 percent in early 1983 to less than 8 percent in July, 1984. By contrast, in the Central and Mountain region, only Sacramento County has experienced a sustained period of sub double digit rates since the recovery began. Most other counties in the region continue to experience unemployment rates in the 12 to 16 percent range, with some counties, such as Stanislaus, having rates as high as 20 percent.

The region's persistently high unemployment rates result in part from structural factors and in part from national and international business events. The structural component relates to the rural nature of most Central and Mountain counties. That is, since agricultural production is highly seasonal, the labor force required during peak times is much larger than that required during the rest of the year. To the extent that these seasonal workers remain in the county throughout the year, the unemployment rate is inflated. Secondly, employment in predominantly ag areas responds much less quickly to national business expansions than other sectors, and hence the statewide unemployment rate fell much faster than for most Central and Mountain counties. Finally, adverse foreign exchange rate conditions have restricted the expansion of agricultural exports (and encouraged imports) and consequently farm and food-related employment has not grown as fast as it otherwise would.

SELECTED ECONOMIC INDICATORS: 33 CENTRAL AND MOUNTAIN COUNTIES OF CALIFORNIA

	1976	1977	1978	1979	1980	1981	1982	1983
Growth in Total Wage and Salary Employment (%)*	3.8	4.1	5.9	4.8	2.0	1.6	-0.8	0.7
Real Growth in Taxable Retail Sales (%)**	8.0	11.2	9.2	3.2	-8.2	0.2	-2.2	10.6
Total Gross Farm Revenue (In \$ Millions)***	5,758.9	5,945.7	6,281.7	8,651.3	9,685.8	9,406.1	8,926.7	8,160.0
Unemployment Rate (%)*	10.1	9.8	9.1	8.4	9.1	10.2	13.4	13.1
Annual Net Migration of Population (000)	76.9	84.8	82.6	81.6	76.1	66.1	62.3	59.0
Annual Housing Unit Authorizations (000)	53.5	63.6	62.6	58.3	35.3	25.4	23.9	40.1

*Based on data from Fresno, Kern, Placer, Sacramento, San Joaquin, Stanislaus, and Yolo counties.

**Adjusted for the "commodities less food" component of the Consumer Price Index.

***Includes Central California's 26 major farm counties.

Residential construction in the Central and Mountain counties has held up well despite an increase in mortgage rates in the first half of 1984. Almost 37,000 new residential units were authorized for construction in the 18 Central Valley counties in 1983, and the annual rate of building permit activity through the first five months of 1984 was 47,460 new units. This represents a 45 percent increase over the same period in 1983; however, the remainder of the year should see some slowing in the rate of residential construction in the Central and Mountain region, with the annual total for 1984 exceeding that for 1983 by approximately 15 percent. In 1985, the number of housing unit authorizations will probably fall below the 1984 total.

The Central Valley is one of the most productive agricultural areas in the country, producing a wide variety of crops and livestock. Much of the region's agricultural industry has seen improved production, better commodity prices, and lower production costs over the past year. However, this improved environment is not shared equally by all ag sectors, since many are burdened with persistently high interest costs and low commodity prices.

Cash receipts for California's agricultural production fell for the first time since 1975, dropping from \$14.3 billion in 1982 to \$13 billion in 1983. This decrease was primarily the result of the reduced production brought about by adverse weather conditions and intentional acreage reductions in response to government programs. Last year's heavy rains delayed the planting

of many crops which reduced yields for some crops. Early fall rain caused difficulties during harvest, particularly for field crops such as cotton. Fruit tree yields were also affected by the rains.

One bright spot for Central Valley farmers and ranchers which should continue throughout 1984 and into 1985 is the moderate increases in production costs. Energy-related costs were stable in 1983, with growers benefiting from actual decreases in the price of gasoline and diesel fuel. This trend has persisted into 1984 and indications are that the price of petroleum products may continue to fall. Labor costs, which were also stable in 1983, may edge up slightly in 1984 since most areas will produce more acreage than last year.

Despite the less-than-normal rainfall this year, water supplies should remain adequate in 1984, largely the result of stored water from 1983's heavy rainfall. More importantly, the relatively dry weather this year has allowed more normal planting and crop set. But there have been periods of extremely hot temperatures which have quickened the maturity of many fruits. This has flooded the markets with large volumes of smaller fruit, keeping prices low in many areas.

Petroleum is another important natural resource which supports a significant part of the economies of many Central and Mountain counties. Kern County, in particular, is a major producer of crude oil, natural gas, and refined petroleum products. While it was believed earlier in the year that crude prices would stabilize in

1984, recent events have led to a weakening of the price structure. While this is good news for petroleum consumers, it means delays or cancellations of the exploration and drilling programs of crude producers, and hence a diminished demand for oil field services which play a significant economic role in some Central Valley counties.

NORTHERN COASTAL CALIFORNIA

At midyear 1984, the Northern Coastal region's economy was enjoying the fruits of the economic recovery that commenced at the end of 1982 and grew in momentum as 1983 unfolded. The region's retail markets were exuberant during the first half of 1984, bolstered by rising incomes and employment as well as by bullish consumer attitudes. Inflation, which was virtually nonexistent in 1983, did rise during the early months of 1984 but by historical standards remained tame. The local economy's job market continued to make headway, with employment on the rise and the unemployment rate trending lower. In the San Francisco Bay Area, the unemployment rate attained an exceptionally low (seasonally-adjusted) level of 5.6 percent by midyear. That rate was the lowest recorded in three years and is at a level considered to be full-employment. The swift and steep drop, in relation to past experience, in the unemployment rate owes as much to a slowdown in the number of entrants to the labor force as it does to the creation of new jobs. Since

the end of 1982, the region's labor pool has increased very slowly, and growth in the first half of this year was practically nonexistent.

In the more rural, non-Bay Area counties of Northern Coastal California, labor markets also experienced an improving trend during the first half, though the improvement was not as swift nor as dramatic as in the Bay Area. Unemployment rates, though heading lower, were typically above those found in the Bay Area. At midyear, the unemployment rate was 6.9 percent in Santa Cruz County, 8.0 percent in Monterey County, 8.9 percent in Mendocino County, and 9.5 percent in Humboldt County.

The sector to lead the economy out of the 1981-82 recession — residential and nonresidential construction activity — remained surprisingly resilient during the first half of 1984 in the face of a worsening financial environment. Signs of a slowdown, however, surfaced at around midyear in the residential market. As the recovery moved into its second year, evidence mounted that capital expenditures by businesses on machinery, tools, and equipment were rising rapidly and providing additional stimulus to the recovery in conformity with past experience. Particularly impressive have been purchases of computers and communications equipment to modernize and enhance the efficiency of the workplace. This trend has greatly benefited local industry, with its emphasis and strength in electronic equipment and semiconductor production.

SELECTED ECONOMIC INDICATORS: NORTHERN COASTAL CALIFORNIA

	1976	1977	1978	1979	1980	1981	1982	1983
Growth in Total Wage and Salary Employment (%)	3.7	4.7	6.0	4.8	3.5	1.5	-0.6	0.6
Real Growth in Taxable Retail Sales (%)*	9.1	11.7	3.3	4.5	-3.5	-3.4	-2.3	10.0
Annual Increase in Consumer Price Index (%)	5.6	7.6	9.4	8.5	15.2	12.8	7.5	N.C.
Unemployment Rate (%)*	8.8	7.6	6.5	5.8	6.0	6.6	8.6	8.2
Annual Net Migration of Population (000)	46.5	41.5	31.3	33.6	44.7	35.9	39.7	47.9
Annual Housing Unit Authorizations (000)	45.5	53.7	46.3	39.9	32.5	20.2	18.8	33.3

N.C. = No Change

*Adjusted for inflation with the "commodities less food" component of the San Francisco - Oakland area Consumer Price Index.

Despite the progress made by the local economy, apprehension and uneasiness surfaced and pervaded the economic environment as midyear approached. Even though the recovery was forging ahead — or perhaps because of it — financial markets exhibited considerable concern over the rise in interest rates and their future direction. In broad outline, the local economy is anticipated to move forward throughout the second half of this year and well into 1985. Along the way, however, momentum will slow, as typically occurs in the latter phase of an economic recovery. A recession is currently not on the horizon, but the emphasis of the recovery will shift from housing and consumer spending to the capital goods sector, as businesses spend more freely to add capacity and purchase up-to-date equipment and machinery. This bodes well for the region's manufacturing activity. All indications point towards an excellent 1984 for the high-tech sector, followed by some slowing in 1985 that actually may be welcomed by the industry.

This rosy outlook may seem at odds with recent announcements of either steamlining of operations or outright plant closures by a few local companies. But such moves are the exception and not the rule in high-tech and, it may be added, not totally out of character in this innovative, fast-paced sector. Those recently laid off should be readily absorbed by the local economy.

Special circumstances will be affecting several of the region's pivotal industries. Deregulation and technological innovations underway in telecommunications and finance have altered the behavioral and operational characteristics of these industries, perhaps in a permanent manner. And the federal government's health care cost containment programs initiated last year have slowed expansion in the health care industry — one of the region's fastest growing sectors in the post war period. Other special events affecting the local economy in 1984 and 1985 are the Democratic National Convention in San Francisco, the Los Angeles Summer Olympic Games, and the Super Bowl at Stanford University in early 1985. The data are projected to show that these events provided an uplift to Northern Coastal California's tourist and travel business, which as been less than spectacular for a number of years.

Inflation is likely to worsen further between now and the end of next year but should remain generally subdued and within a tolerable range. In the international trade sector, the region's import volumes are expected to remain quite strong while exports should finally revive from their moribund state, given the growth exhibited by the region's principal Asian

trading partners. However, the persistent strength of the dollar vis-a-vis other currencies will continue to hamper exports from the region.

Mid 1984 saw signs of a slowdown surfacing in the region's homebuilding industry and real estate market, as the rise in mortgage interest rates that commenced in late winter was beginning to impact the housing market. But the increasing popularity of adjustable rate mortgages and the re-institution of mortgage revenue bonds are projected to keep credit flowing in ample supply to the housing market and limit the impact of higher mortgage rates. The local housing market is anticipated to recede in the second half of this year but still show an overall annual increase for 1984. The slowing in the second half is likely to extend into next year, with the housing market showing a year-over-year drop in sales and construction. The 1983-84 increase in the region's housing unit authorizations is estimated at 10 percent, while 1985's figures will likely be closer to the 1983 total. The region's home prices failed to exhibit any strong upward pressures during January-June of this year and are unlikely to do so through 1985.

1984 is shaping up as a strong year for the region's nonresidential construction. In fact, during the first five months, nonresidential development was proceeding beyond anyone's expectations, with permit valuations exceeding year-ago levels by 15 percent. The upward thrust was led by development of industrial projects — warehouses and manufacturing facilities — most of which are slated for Santa Clara County. And given the capacity needs of that county's high-tech sector and other industries, this fast pace of development could very well persist into 1985. Growing demand for office and retail space in the Northern Coastal region, owing to the recovery coupled with ample sources of funds and accelerated depreciation should continue to impact commercial activity favorably. To date, developers' plans seem not to have been slowed by relatively high office vacancy rates in some markets.

The region's favorable labor market conditions should prevail throughout the balance of this year, followed by a slackening in the job market next year. In the San Francisco Bay Area alone, about 85,000 nonfarm jobs are expected to be created during 1984 and another 70,000 next year. Local companies may find it difficult to fill all of those vacancies given the region's current low level of unemployment and the sharp slowdown in the number of people entering the labor force. One mitigating influence may be an increase in migration induced by Northern Coastal California's bright job prospects. ■

THE SHORT-TERM U.S. OUTLOOK

THE OUTLOOK FOR REAL GROWTH

The U.S. economy in the fall of 1984 is in transition from a period of exceptionally rapid growth to one of a much more moderate expansionary trend. Although interest-sensitive sectors such as housing and auto sales are projected to decline from recent, unsustainably high levels of production and sales, no drop in total output is foreseen through the end of 1985. Real GNP expanded 11 percent from the third quarter of 1982 through this year's second period — equivalent to an annual growth rate of 6.1 percent. Real growth is expected to drop to about a 3 percent rate late this year, with only a 1.7 percent increase from this year's fourth quarter through the final period of 1985.

Consumer spending will be a source of stability in the late 1984 and 1985 economy. Although auto sales are likely to have peaked this summer at an annual rate close to 11 million, car sales should remain above the 10 million level through most of 1985 as strong replacement demand is only modestly discouraged by tighter credit and lower consumer confidence. Retail spending for nondurable goods and services should record a 3 percent average gain in 1985. Food purchases are likely to be the fastest growing category of consumer nondurable goods, and expenditures related to housing will lead the services sector.

Although the growth trend of investment spending is expected to weaken through 1985, it will be slowing from the first half, 1984, gain of 21 percent at an annual rate. Although part of the slowing of growth in capital spending will be due to a weaker trend in output and sales, it also reflects expected higher interest rates, weaker corporate equity financing, and deteriorating profitability in 1985. Both the producers' durable equipment and structures categories of investment are projected to show year-over-year gains of about 8 percent, with far lower rates in the second half of the year.

The volume of housing activity is likely to decline late this year and next in response to the already worsening credit situation for residential real estate. The drop will be mitigated, however, by continued reliance on adjustable rate mortgages for an important proportion of total home purchases. Housing starts are likely to fall from this year's peak quarterly reading of 1.97 million units, recorded in the first quarter, to 1.5 million units by the fourth quarter of 1985.

The federal government will remain a very stimulative force in the 1985 economy. Real federal spending will be growing even faster in 1985 than in 1984, assuming no major new budget cuts. This forecast assumes that real defense spending will grow about 6 percent next year, while nondefense spending will stabilize at a level almost 11 percent above that of 1984, which was depressed by the PIK program early this year. State and local government spending will benefit from an improved revenue position, as this year's growth in the tax base exceeded expectations by a substantial amount.

FORECAST HIGHLIGHTS

1983-1985
(Billions)

	1983A	1984F	1985F
Gross National Product	3304.8	3682.1	3975.7
% Change	7.7	11.4	8.0
Real GNP (1972 \$)	1534.7	1645.2	1690.1
% Change	3.7	7.2	2.7
GNP Deflator (1972 = 100)	215.3	223.8	235.2
% Change	3.8	3.9	5.1

A = Actual

F = Forecast

The next export sector of the U.S. economy is expected to remain in a deficit position through the rest of this year and throughout 1985. The prospects for 1985 on the whole are less negative due to an improving trade picture based on a slowing of growth in the domestic economy. Although the dollar's trade-weighted value is likely to decline somewhat from its current level in 1985, the decline is not likely to be either precipitous or unbroken, in our view.

In summary, the remainder of 1984 is likely to be a transitional period of lower growth that will be followed by some declines in interest-sensitive sectors of the economy next year. Weakness in the residential investment and consumer durable goods sectors will be offset, however, by sustained growth in consumer spending for nondurable goods and services, business capital spending, and government purchases. Additions to business inventories are likely to exceed growth in final sales in the remainder of 1984 and 1985, resulting in some unintended buildup and raising the possibility of an inventory recession sometime in 1986.

OUTLOOK FOR INTEREST RATES

The combination of rising credit demands and credit-supply restraint on the part of the Federal Reserve will work to push interest rates even higher during the latter part of 1984 and into 1985. Security Pacific Bank's forecast calls for the prime rate to move toward 14 percent at year-end 1984 and 15 percent by mid-1985. Seasoned high-grade corporate bond rates are expected to rise from their current level in the low-13 percent range to 14.50 percent by mid-1985. Except for brief periods of decline from time to time, we are now in the portion of the business cycle when the basic direction of interest rates is upward. It appears very unlikely that interest rates will fall to any significant degree before the next business cycle peak — which we do not expect before 1986.

THE POLICY OUTLOOK

A key ingredient in next year's economy will, as always, be the course of fiscal and monetary policies. Fiscal policy has been highly stimulative since 1982 — helping propel the economy forward. Monetary policymakers, on the other hand, began to tighten credit availability in mid-1983 and have persisted in this course of action during 1984.

The federal budget deficit declined from \$195 billion in fiscal year 1983 to just under \$175 billion in 1984. Further progress is not likely next year, however, since tax rate indexation begins in January and will cut substantially into revenue growth. The budget deficit is thus expected to rise to the \$180 to \$190 billion range in fiscal year 1985. An actual budget deficit of this size implies a cyclically-adjusted deficit of well over \$100 billion which is highly stimulative by any historical comparison.

The Federal Reserve will come under increased pressure in the year ahead. Still-large Treasury borrowing, coupled with rising private credit demands, will put strains on credit markets — pushing credit growth higher and causing concern on the part of monetary policymakers. The end result will be an even tighter monetary policy as policymakers attempt to hold the next inflation peak significantly below the last.

CONSUMER SPENDING

Consumer spending for goods and services contributed much of the strength in final sales (GNP less the change in inventories) during the first half of 1984, and will help to sustain the expansion through year-end. Typically, consumer spending for durable goods leads the economy out of recession. However, total consumer spending, which is dominated by nondurable goods and services, is less cyclical than total output due to the greater cyclicity of categories such as business inventories, capital spending, and residential investment, which are much more sensitive to credit conditions. Real consumer spending grew about 10 percent from the third quarter, 1982, recessionary trough in real GNP through the second quarter of 1984, compared with an 11 percent gain in real GNP. During the first half of 1984, consumer spending increased at an annual rate of 5.8 percent, compared with 6.9 percent for real GNP.

Consumer spending in 1984 is receiving its impetus both from purchases that were postponed from prior periods and from strong gains in income and employment. As recently as last year, the average age of a car in the U.S. was reported to be near seven years, a figure indicating a considerable need for replacement. At the same time, consumer confidence measures and buying intentions were also nearing all-time highs, giving some signal of the explosion in consumer spending that was coming.

ECONOMIC OUTLOOK **Selected Economic Indicators**

Item	1984				1985				Annual		
	I	II	III ^F	IV ^F	I ^F	II ^F	III ^F	IV ^F	1983	1984 ^F	1985 ^F
Housing Starts*	1.97	1.91	1.80	1.75	1.65	1.60	1.55	1.50	1.70	1.86	1.58
Automobile Sales*	10.5	10.7	10.8	10.6	10.5	10.3	10.1	9.9	9.2	10.6	10.2
Personal Income	2920.5	2984.8	3046.8	3102.4	3159.0	3209.1	3266.1	3325.0	2744.2	3013.6	3239.8
% Change	12.4	9.1	8.6	7.5	7.5	6.5	7.3	7.4	6.4	9.8	7.5
Disposable Personal Income	2502.2	2557.6	2605.3	2651.0	2703.8	2745.7	2792.2	2839.9	2340.1	2579.0	2770.4
% Change	12.7	9.2	7.7	7.2	8.2	6.3	6.9	7.0	7.5	10.2	7.4
Saving Rate (%)	6.1	6.0	5.8	5.7	6.0	5.8	5.7	5.7	5.1	5.9	5.8
Industrial Production Index**	159.8	162.9	165.1	166.8	168.4	168.9	169.2	169.4	147.6	163.7	169.0
% Change	11.5	8.0	5.5	4.2	3.9	1.2	0.7	0.5	6.4	10.9	3.3
Labor Force	112.6	113.6	114.2	114.8	115.3	115.8	116.3	116.7	111.5	113.8	116.0
Employment (Non-Agricultural)	92.8	93.7	94.4	94.9	95.2	95.4	95.4	95.4	90.0	93.9	95.4
Unemployment Rate (%)	7.9	7.5	7.2	7.0	7.1	7.3	7.4	7.4	9.6	7.4	7.3
Producers Price Index** Finished Goods	290.3	291.5	293.0	296.5	300.3	304.3	308.6	313.5	285.1	292.8	306.7
% Change	4.5	1.7	2.1	4.9	5.2	5.4	5.8	6.5	1.6	2.7	4.7
Consumer Price Index**	306.8	309.6	312.0	315.8	319.9	324.3	329.0	334.1	298.3	311.1	326.8
% Change	5.0	3.7	3.1	5.0	5.3	5.6	5.9	6.3	3.2	4.3	5.1

*Millions

** (1967 = 100)

F = Forecast

Until fairly recently, consumer indebtedness has maintained a ratio to disposable personal income that was well below the historic high of 17.9 percent reached in 1979. After several months of record high consumer borrowing, however, the debt ratio reached 16.5 percent of disposable income in the second quarter. We expect consumer borrowing to slow considerably from its recent pace in late 1984 and 1985. Continued gains in real disposable income and employment, along with a more cautious approach to borrowing, will support a reduced growth rate of real consumer spending through 1985.

We think that the peak sales rate for autos, at an annual rate of about 11 million units, has already been attained, and that sales will fall gradually back to the 10 million unit rate by late next year. Although this is a fairly healthy sales level for the restructured U.S. auto

industry (assuming domestic sales of about 7.7 million next year), it does indicate a decline in 1985 real GNP spending for autos and parts. Other durable goods, consisting mainly of home furnishings and appliances, will offset the weakness in autos to some extent, although this category will be growing more slowly than its recent pattern.

Consumer spending for nondurable goods and for services will provide a foundation for the 1985 economy that should insure against a downturn in total output. Nondurable purchases of food, clothing, and shoes should be maintained at a fairly high level, at a real growth rate above 3 percent. Other nondurable goods categories, such as gasoline and oil, and other fuels, should experience very little growth. In the services sector, housing and transportation will be the main components of a robust outlook, with projected real growth rates of more than 3 percent.

OUTLOOK FOR REAL GROWTH
(Percent Change)

Item	1984				1985				Years		
	IA	IIA	IIIF	IVF	IF	IIF	IIIF	IVF	1983A	1984F	1985F
Gross National Product	10.1	7.5	4.5	3.1	2.2	1.5	1.6	1.5	3.7	7.2	2.7
Personal Consumption Expenditures	4.6	6.9	4.0	2.4	2.4	1.9	1.7	1.3	4.8	5.4	2.6
Durables	16.5	9.3	5.3	-0.9	0.2	-1.3	-1.3	-2.2	12.1	12.8	0
Motor Vehicles & Parts	17.7	11.6	4.7	-7.9	-5.6	-8.2	-7.9	-9.6	16.9	15.3	-4.2
Other Durables	15.6	7.5	5.7	4.8	4.7	3.9	3.5	3.1	8.8	11.1	4.6
Nondurables	4.1	9.5	3.7	2.8	2.5	2.4	2.2	1.8	3.7	5.3	3.0
Services	1.2	3.9	3.8	3.3	3.0	2.6	2.4	2.2	3.4	3.1	3.0
Gross Private Domestic Investment	71.5	1.0	8.7	1.0	-0.8	-2.2	-1.5	-1.2	13.7	30.9	0.4
Fixed Investment	20.8	18.0	7.6	3.5	1.2	0.9	0.6	0.1	9.7	18.0	3.1
Nonresidential	20.5	20.7	11.7	8.9	6.9	5.3	4.3	3.3	2.5	19.4	7.8
Producers' Durable Equipment	19.6	17.5	11.1	8.9	7.3	5.5	4.7	3.6	7.3	20.1	7.7
Structures	23.2	29.2	13.0	9.0	6.1	4.6	3.2	2.6	-7.8	18.0	7.8
Residential	20.8	9.6	-5.1	-13.6	-17.7	-14.8	-13.3	-12.4	41.7	13.1	-12.4
Change in Inventories (\$)	31.6	21.5	22.7	21.1	19.7	17.5	16.0	15.0	-3.6	24.2	17.1
Government Purchases	1.0	19.1	4.2	4.0	3.8	2.9	2.8	2.8	-0.3	3.3	4.4
Federal	-2.8	47.7	6.6	6.2	6.1	4.1	4.4	4.3	-0.6	5.2	7.5
National Defense	3.8	13.0	6.4	5.8	6.2	5.7	5.6	5.5	7.1	6.4	6.3
Nondefense	-20.6	231.4	6.0	7.1	5.8	0.0	1.1	1.1	-16.9	2.3	10.8
State and Local	3.5	3.2	2.5	2.5	2.2	2.0	1.8	1.8	.0	2.0	2.2
Net Exports (\$)	-8.3	-10.0	-11.3	-8.6	-8.1	-7.3	-6.4	-5.0	12.6	-9.6	-6.7
Exports	11.5	11.2	4.9	14.2	5.8	7.0	7.4	8.3	-5.6	7.6	8.1
Imports	47.1	15.4	8.0	6.1	4.2	4.7	4.9	4.5	7.6	25.8	5.9
Final Sales	3.6	10.4	4.3	3.6	2.6	2.1	2.0	1.8	3.2	5.4	3.2

A = Actual F = Forecast

THE OUTLOOK FOR INVESTMENT

While the strength of the current economic expansion continues to surprise many analysts, the performance of private fixed investment in 1984 has been nothing short of astonishing. After falling 3.3 percent from 1981 to 1983, real investment spending jumped at a phenomenal annual rate of 21 percent in both the first and second quarters of 1984. Although investment is usually more sensitive to the business cycle, these figures left even the most optimistic forecasters far from the mark. Even though recent capital spending activity has been advancing remarkably, it should be noted that the long-term record for capital spending

since the 1960s has not been particularly strong. Between the late 1960s and 1970s, the share of real output devoted to nonresidential fixed investment has declined by more than 30 percent, while the growth rate of the nonresidential capital stock decreased nearly 40 percent.

Our analysis suggests that some of the most important factors which have affected private investment are the rate of inflation, the existing tax structure, and the performance of common stock prices. The interactive effects of inflation and the existing tax code distort the relative return to business capital in two principal ways. First, an increase in the rate of inflation lowers the real value of depreciation allowances. This is an especially significant problem during periods of unanticipated inflation. Secondly, common stock shareholders pay capital gains tax on nominal increases in the value of their stock. During inflationary periods, this means that personal investors must pay taxes on price appreciation even if the real value of their equity has declined. Inflation does provide an incentive for firms to issue debt since nominal interest payments can be deducted from firms' taxable income. However, this effect is partially offset because bondholders, like stockholders, pay taxes on nominal interest income. The current strength of capital spending, therefore, reflects both a substantial reduction in the rate of inflation and recent favorable changes in business depreciation schedules.

Recently, interest in the "Q-theory" of investment has been renewed. Developed by Nobel Laureate James Tobin, the Q-theory examines the relationship between the behavior of investment and the behavior of common stock prices. The theory is based on the observation that securities prices, which represent the market value of publicly-held corporations, are much more volatile than prices of new capital goods. When stock prices rise faster than the replacement costs of capital, investment tends to increase, since any addition to a firm's capital stock will be valued at a higher price (in the stock market) than the acquisition cost.

Empirically, the Q-theory explains recent investment behavior quite well. During the 1970s, the purchase price of capital advanced rapidly, while real common stock share prices fell. As a result, the growth rate of capital spending declined markedly during the decade. Similarly, the current boom in investment coincides well with the 1982-1983 surge in stock prices.

Although some economists are not terribly worried about the effects of current and future budget deficits on the economy, it's generally agreed that large federal borrowing poses a significant problem for private business capital funding. The basic thesis is that heavy public sector borrowing, coupled with private credit demands for scarce loanable funds, necessarily drives up real interest rates and eventually "crowds-out" the private sector from the credit market.

Although current interest rates already reflect expectations about future deficits, it is not at all clear the degree to which federal borrowing will affect private investment. One method which has been increasingly used to analyze this problem is a concept known as the financing gap, which measures general external financing needs, and is usually defined as business investment less internally generated cash flow. This measure already suggests the possibility of tight credit markets in 1985. The financing gap, which averaged \$22.1 billion in 1983, is expected to approach \$55 billion by the end of 1984 and even higher next year. This increase reflects rising interest rates, weak corporate equity financing, and deteriorating corporate balance sheets.

As the financing gap widens and corporate debt grows, a significant slowing in the growth of investment should occur. Also, other important factors affecting investment have not been strictly positive. The recent volatility of stock prices reveals a growing uncertainty, while inflation (though still very modest) should rise over the balance of the year. We see no compelling reasons, however, to expect private investment activity to collapse in coming quarters.

Security Pacific Bank's forecast calls for nonresidential investment to advance about 8 percent in 1985, reflecting similar increases in both producers' durable equipment and nonresidential structures investment. An important assumption behind this forecast is that no major changes to the tax code become effective by next year. Any substantial tax increases would reduce potential gains in capital spending.

CORPORATE PROFITS

Corporate profits are continuing to show a strong expansion in 1984 following last year's substantial gains. Earnings should peak in the first half of 1985 and should begin to decline late next year with the pronounced slowing of the economic expansion expected during that period. For nonfinancial corporations, the near-term strength in profits will reflect both higher output levels and improved margins. Financial corporations, however, have already seen some erosion from late year's profit levels due to reduced margins and higher loan losses, and thrift industry earnings are projected to suffer from the housing downturn projected for later this year and in 1985. Profits from abroad are expected to show a modest improvement as a result of the projected recovery in other countries this year and next.

The trend in pre-tax profits has been obscured during the last several years by changes in depreciation schedules allowed under the Economic Recovery and Tax Act (ERTA) of 1980. The accelerated depreciation allowed by ERTA resulted in a substantial increase in depreciation expenses and a corresponding reduction in profits before taxes in subsequent years. The broader category of operating profits, which is measured prior to adjustment for depreciation (or "capital consumption") and inventory valuation changes, gives a better picture of the current economic forces influencing changes in profits.

Operating profits of nonfinancial corporations have been affected dramatically by the economic recovery that began in late 1982, and increased 41.5 percent on average during 1983. The substantial improvement of 1983 was the result of strong output gains combined with much improved margins. The real output of nonfinancial corporations gained 4.5 percent in 1983, compared with the 3.7 percent output gain of the entire economy. At the same time, margins were benefiting from the slowdown of production costs. Unit labor costs increased just 0.8 percent in 1983, compared with the 7.1 percent gain of 1982, and productivity jumped from a 0.1 percent rise in 1982 to 3.3 percent in 1983. Compensation expenses — the largest components of unit costs — rose only 4.2 percent.

Although profits continued to grow strongly early in 1984, the large output gains of the first half are not likely to be repeated in the forecast period. Real output of nonfinancial corporations, which grew at an estimated annual rate of 9.5 percent in the first half, is expected to slow to a 4.7 percent increase in the second half. From the fourth quarter of 1984 through the fourth quarter of 1985, this output growth is projected to slow further, gaining only 1.5 percent in real terms.

Profit margins will also be narrowed by a number of unfavorable factors. Productivity growth is likely to be much lower in the remainder of 1984 and in 1985 than it has been thus far in the expansion. Unit labor costs are projected to accelerate, returning to the 5 to 6 percent range in 1985 following a modest 1.6 percent rise expected for 1984. Rising interest rates will also have an adverse effect, with unit interest costs expected to climb 13 percent from the second quarter of this year through the end of 1985.

CORPORATE PROFITS OUTLOOK

	\$ Billions			Percentage Changes		
	1983A	1984F	1985F	1983	1984	1985
Operating Profits	225.2	294.2	301.1	41.5	30.6	2.4
Capital Consumption Adjustment	33.2	52.6	60.1	—	—	—
Inventory Valuation Adjustment	-11.2	-10.5	-22.7	—	—	—
Corporate Profits Before Taxes	203.2	252.1	263.8	22.8	24.1	4.6
Corporate Profits After Taxes	127.4	159.3	169.4	21.5	25.0	6.3
Book Depreciation	264.4	295.3	323.5	17.6	11.7	9.5
Gross Cash Flow	391.9	454.7	492.8	18.9	16.0	8.4
Dividends	72.9	77.5	81.8	5.2	6.3	5.6
Cash Flow Less Dividends	319.0	377.2	411.1	22.5	18.3	9.0
Operating Profits / GNP	6.8	8.0	7.6	—	—	—
Before Tax Profits / GNP	6.1	6.8	6.7	—	—	—
Nonfinancial Corporations						
Compensation per Hour	—	—	—	4.2	4.6	6.5
Productivity	—	—	—	3.3	3.0	0.8
Unit Labor Cost	—	—	—	0.8	1.6	5.6

A = Actual F = Forecast

The net effect of reduced output growth and narrower earnings margins will be to produce only a modest gain in profits in the second half of 1984, followed by a declining trend next year. Although operating profits are projected to increase 2.4 percent *on average* in 1985, declines will be experienced in every quarter except the first next year. Similar quarterly patterns are expected for both pre-tax and after-tax profits which will show average gains of 4.6 percent and 6.3 percent, respectively, but which will actually be declining through most of next year.

THE OUTLOOK FOR INFLATION

One of the most important economic developments of the last two years has been the substantial decline in the nation's rate of inflation. Although many economists had predicted modestly lower inflation for 1983 and 1984, very few anticipated the dramatic deceleration which has occurred.

Measured by any price index, inflation in 1983 was but a small fraction of its previous values. For example, the Consumer Price Index, which rose 13.5 percent in 1980 and 10.3 percent in 1981, rose just 3.2 percent last year. Similarly, the GNP deflator, which is generally regarded as the broadest measure of inflation, advanced just 4.2 percent in 1983 after recording gains near 9 percent both in 1980 and 1981.

With the exception of January, the trend of lower inflation has continued into 1984 as well. The Consumer Price Index rose at less than a 4 percent rate during 1984's second quarter, while producer prices rose at less than a 2 percent rate.

The most recent data in aggregate prices have clearly caught many economists by surprise. Not only had the majority of forecasters predicted higher inflation for 1984 and 1985, but several had estimated that prices would rise by more than 9 percent. Their argument was based on the fact that both monetary and fiscal policy were very accommodative and that inflation historically has been positively correlated with the business cycle. Although total demand for goods and services has grown substantially, price increases have been kept very modest by the fact that the total output of goods and services in the economy has also grown rapidly.

From a short-run viewpoint, measured inflation also reflects significant changes in important relative prices. Many economists have suggested that the severity of our most recent experience with inflation can be partially traced to the substantial price increases which occurred in the energy and food sectors during the late 1970s. Those factors undoubtedly pushed measured inflation higher, just as declining energy prices and abundant harvests have had a moderating effect on the cost of living. However, it is important to remember that significant changes in sectoral prices can have only transitory effects on inflation, because they are changes in the relative price of good, not the general level of prices.

Good news on energy costs should continue. Spot market prices for Saudi Arabian light crude oil recently fell \$2 to \$3 under posted list prices, and were stabilized only by concerted action of the British government and the Saudis. Nevertheless, oil producers are rumored to be discounting by some \$2 to \$3, particularly in barter agreements. Additionally, the end-product market is weak and with oil refiners operating at only 70 percent of capacity, there should be little upward pressure on spot oil prices through 1985.

Wage gains should continue to be moderate over the forecast period. The hourly earnings index advanced by only 3.2 percent in the 12 months ending in June, compared with 4.7 in the previous 12 months. Moreover, this trend is apparent in every one of the private nonfarm sectors except mining. Additionally, recent settlements in the copper, aluminum, and steel industries call for modest wage increases of approximately 5 percent annually.

On balance, food price increases ought to remain modest through 1985. Beef prices should rise as ranchers continue to trim herds, but increases should not be particularly troublesome as the demand for meat has remained surprisingly soft. Despite unseasonably hot weather in the Midwest, grain harvests are expected to be large and will add considerably to current surpluses.

An additional factor which has positive implications for inflation has been the restraint on the part of the Federal Reserve. After growing at approximately a 10 percent rate in late 1982 and mid-1983, the nation's money supply (consisting of currency, demand deposits, other checkable deposits and travellers' checks) advanced by just over 6 percent during the last year. Although this degree of monetary growth is not compatible with long-term price stability, it will not likely produce the type of inflation we experienced in the mid- and late 1970s.

Security Pacific Bank's forecast calls for the Consumer Price Index to rise 4.3 percent in 1984 and more than 5 percent in 1985, while the Producer Price Index is expected to advance 2.7 percent this year and close to 5 percent in 1985.

EMPLOYMENT OUTLOOK

Since the trough of the recession in November, 1982, the nation's unemployment rate dropped from its peak of 10.7 percent to 7.1 percent in June, 1984. This is the most remarkable improvement in the first 20 months of any post World War II recovery. Payroll employment rebounded from 89.8 million workers in November, 1982, to 94.1 million in June, 1984, with gains in every major category. Industries that were hard hit by the latest recession, such as autos, manufacturing, and construction, had expanded their payrolls beyond pre-recession levels. Strong employment growth also led the labor force participation rate to a steady climb, reaching a record 65 percent in May, 1984, despite some rapid labor force gains during the first 20 months of expansion.

We expect the nation's unemployment rate to reach a quarterly average low of 7 percent, and nonagricultural payroll employment to expand to over 95 million, by the end of 1984. However, as the economic growth begins to slow down in 1985, higher interest rates and slower consumer spending will dampen the employment outlook. Employment growth should increase by a slight 1.6 percent, compared to over 4.3 percent in 1984. The civilian unemployment rate will climb back to about 7.4 percent at the end of 1985 as a result of a weaker economy and continued labor force growth.

INTERNATIONAL DEVELOPMENTS

The net export position of the United States is anticipated to remain in deficit through the rest of 1984 and for the whole year 1985. Quarterly results are expected to be less negative as we move into the last semester of 1984, however, due to an improving trade picture based primarily on a slowdown in the domestic economy.

The key question at this time is whether trends suggest that the dollar will remain fundamentally strong and that any future decline will be small, or, alternatively, whether it is approaching the edge before a precipitous fall. In both views the impact of interest rate differentials is fundamental. However, the first of these two very conflicting outlooks about the U.S. currency assumes that the differential will remain large and that continued large capital inflows will continue to maintain the dollar's strength. These inflows are seen as offsetting the huge current-account deficits expected for 1984 and 1985, about \$80 billion for each year.

The second view highlights the fact that real interest rate spreads between the United States and other major countries have begun to narrow. There are two reasons for this narrowing. First, inflation has slowed down in other countries. Second, authorities in some countries have accommodated rises in nominal interest rates to counter higher U.S. rates. Additionally, some observers feel that U.S. interest rates may already have begun a sustained downward trend. Narrowing of interest rate spreads, coupled with the current-account deficit, suggest, in this view, that the dollar is in for a significant decline.

We subscribe to the view that the dollar is near to topping-out, although we do not expect the decline to be either precipitous or unbroken. A dramatic narrowing of real interest rate differentials does not seem likely. Even if U.S. rates should start a sustained decline, the economic managers of other countries are poised to take steps to lower their own interest rates, in order to sustain the recovery process. Moreover, in our view the inflation differential between the U.S. and most other major countries is not expected to change significantly.

Also underpinning the view that the decline in the value of the dollar will not be rapid or consistent are numerous other political and financial factors. The two most complex of these arise from, firstly, the developing-country debt problem, and, secondly, the current decline in oil prices, which would be greatly accelerated by any breaks in OPEC unity.

The debt problem and related international banking issues could be viewed as initially negative to the dollar because of its lower interest rate implications; that is, if extra liquidity is in fact injected into the world financial system to ease developing-country strains. By the same token over the longer term, the developing-country debt could favor dollar strength because its solution implies continued strong foreign demand for dollars.

Similarly, the initial impact of lower oil prices could suggest dollar weakness through a reduction of U.S. inflation and interest rates. Ultimately, however, the effect would be to drive the dollar upwards, especially if the result should be the removal — after much buffeting — of the OPEC hammer, because a potential threat to the dollar will have been removed by the breakup of OPEC.

Finally, international political shocks generally favor the dollar due to the role of the dollar and the United States as a political safe-haven. All factors considered, in spite of the prospects for weaker economic fundamentals and occasional technical adjustments to interest-rate shifts, any decline in the value of the dollar is anticipated to be more hesitant rather than precipitous.